

# THE ECONOMIC SITUATION

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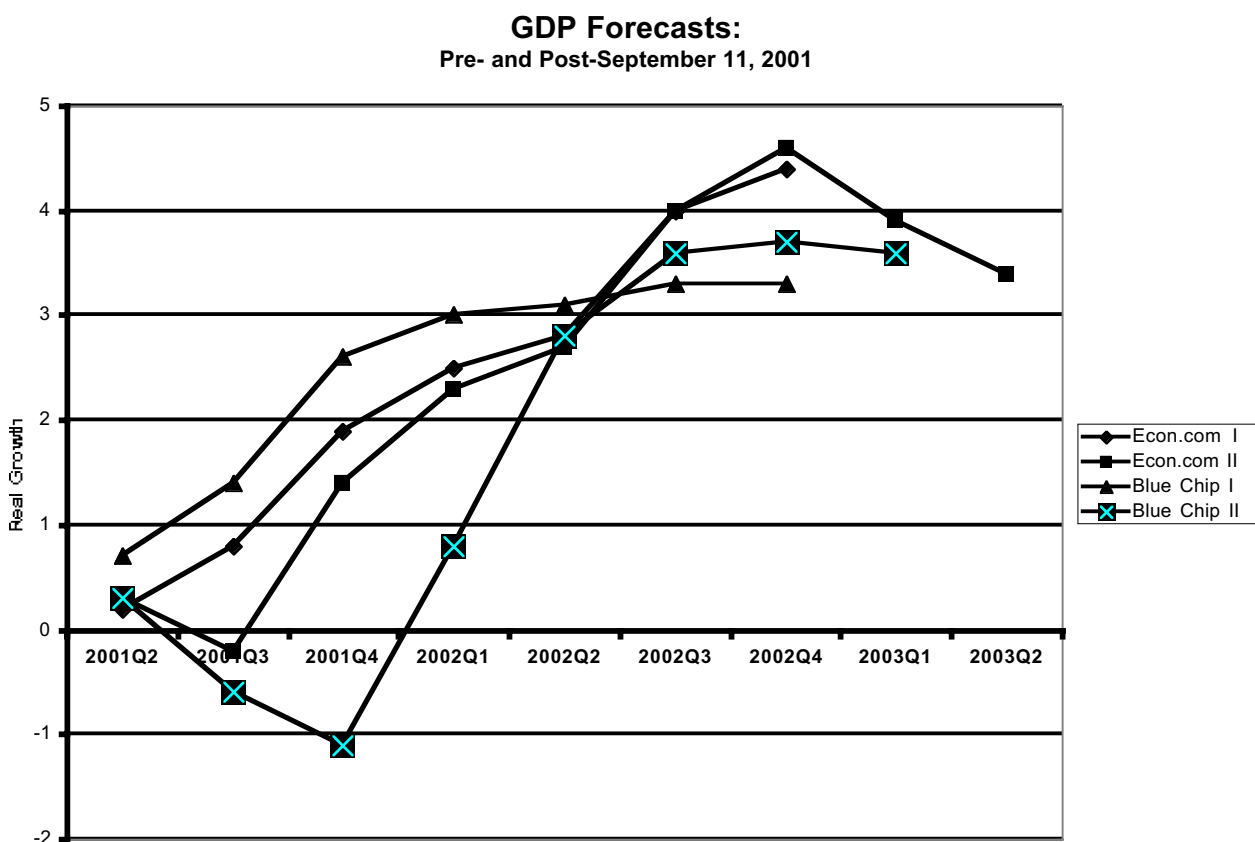
A quarterly report on economic trends.

WINTER 2001

- September 11 and the revised forecasts.
- A recession? It's official.
- Did the forecasters see it coming? When will it end?
- Do vanishing interest rates really matter?
- How about South Carolina, the nation's secret auto economy?
- Gold and Oil: The 20-barrel an ounce rule.

## How September 11 Changed the forecast.

The events of September 11 and those that followed brought fundamental change to the way we Americans move, think, and have our being. In the midst of all the profound and tragic events, people who seek to describe the economies future were working to revise their forecasts. The chart here gives one rendering of how September 11 changed expectations about the nation's economy.



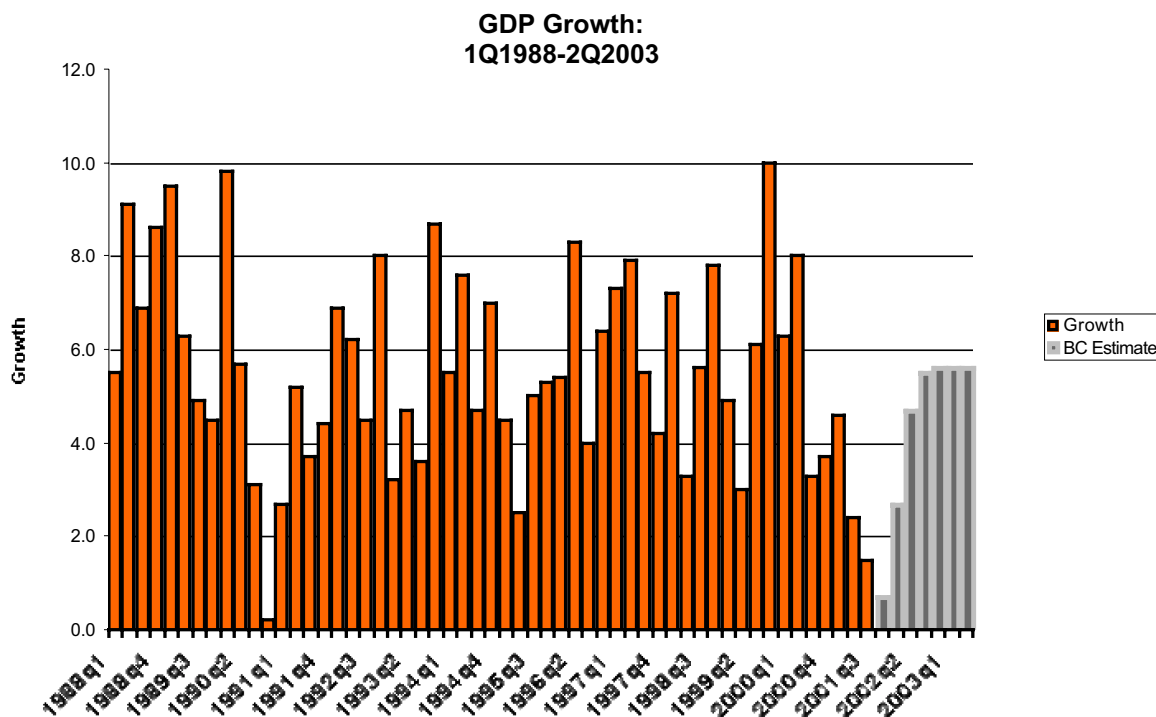
There are four forecasts displayed in the chart. These are the pre- and post-September 11 for Economy.com and the Blue Chip Forecast. For the sake of discussion, let's focus on the two Blue Chip forecasts. Here we see how optimism about the immediate future of the economy turned to deep pessimism, and how an expected recovery was converted to recession.

The Blue Chip post-911 forecast shows a recession forming, but also shows an accelerating recovery that exceeds the pace of the pre-911 forecast. Here we see the expected effects of increased spending, interest rate cuts, and other actions taken to counter terrorism here and abroad. It is important to note that the optimistic recovery path first rises and then falls toward 3% GDP growth. In short, the longer term future is not as bright as the past when real GDP growth averaged or exceeded 4% annually. This may another way of saying there is no such as a free lunch.

## **A 10-year run for the gold has ended.**

It's now official; the nation is in a recession, a slowing of the economy that began in March when employment growth ended a 10-year expansion. So says the National Bureau of Economic Research, the organization that officially dates the cycles that describe U.S. economic activity. On hearing this news, those in nation's factory economy probably shrugged and said "Tell me about it." Industrial production has fallen every month since September 2000. With a factory recession well underway, but showing early signs of ending, September 11 pushed the economy over the edge. In a way, it was fairly easy to see how September 11 would do so. After all, with GDP growth barely in positive ground anyway, it did not take much to go negative. Certainly, the equivalent of three days of activity were lost to terrorism, and that is roughly one percent of a year's work.

The chart here shows nominal GDP growth, that's without adjusting for inflation, for the last five years and provides the Blue Chip forecast for the next seven



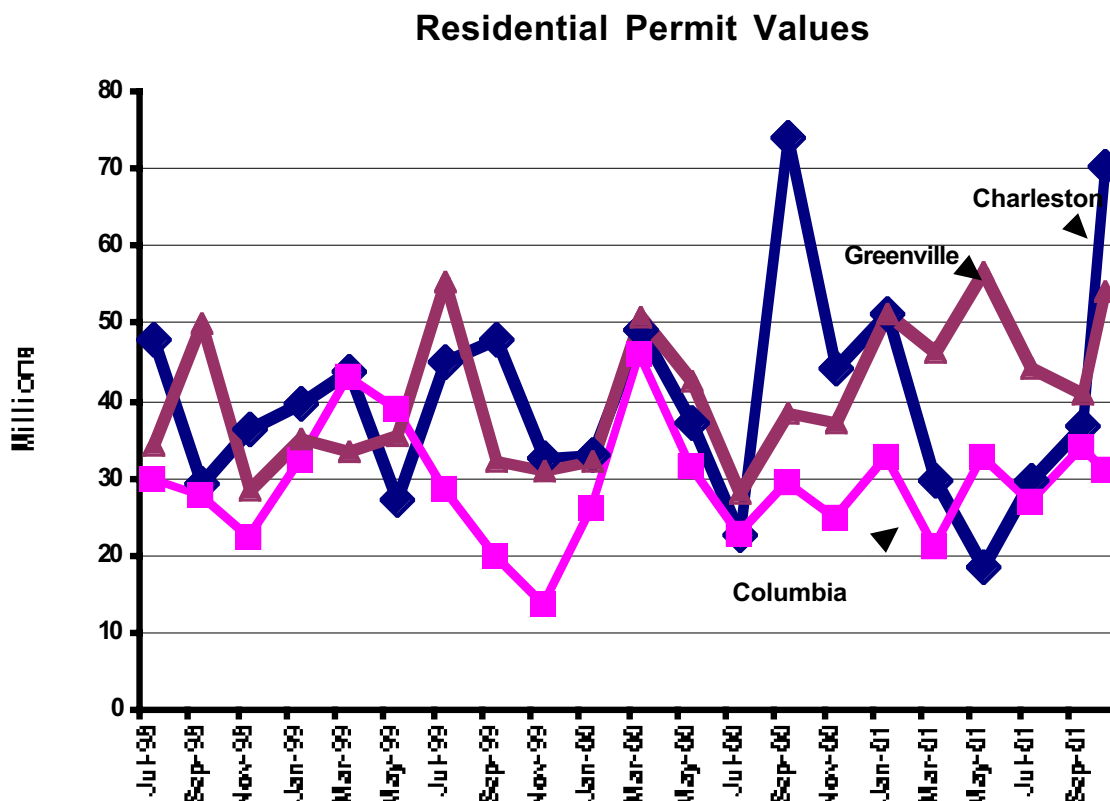
quarters. In the chart, we can see the 1990-91 recession. It was sharp and quick. Now, consider the current recession. Once again, forecasters expect the economy to bounce back rather quickly. But notice, they do not expect to see the economy bounce as high in the quarters that lie ahead. In other words, a golden era ended when the current recession began.

## Do vanishing interest rates really matter?

Starting in January when the Prime rate stood at 9.50%, the Federal Reserve Board has reduced interest rates 10 times. In November, the Prime stood at 5.00%, and bets were in place for at least one more Fed-induced rate reduction. While all this was underway, a lot of people argued that nothing was happening. Even worse, some analysts argued nothing could happen. The nation was in shock after 9/11. It would take more than interest rate cuts to get things going again.

To some extent our impatience with the lag between interest rate changes and changes in economic activity derives from the world of instant satisfaction in which we live. We want instant coffee, instant photos, and instant victory when the nation is at war. But some things still take time. Even in this world of instant action it takes nine months from the time of conception for a newborn baby to arrive. And it takes a bit longer than that for interest rate reductions to have an effect on the economy.

We can see the effect of lower interest rates in the next chart, which shows data on the value of residential housing permits issued in three S.C. metropolitan areas.

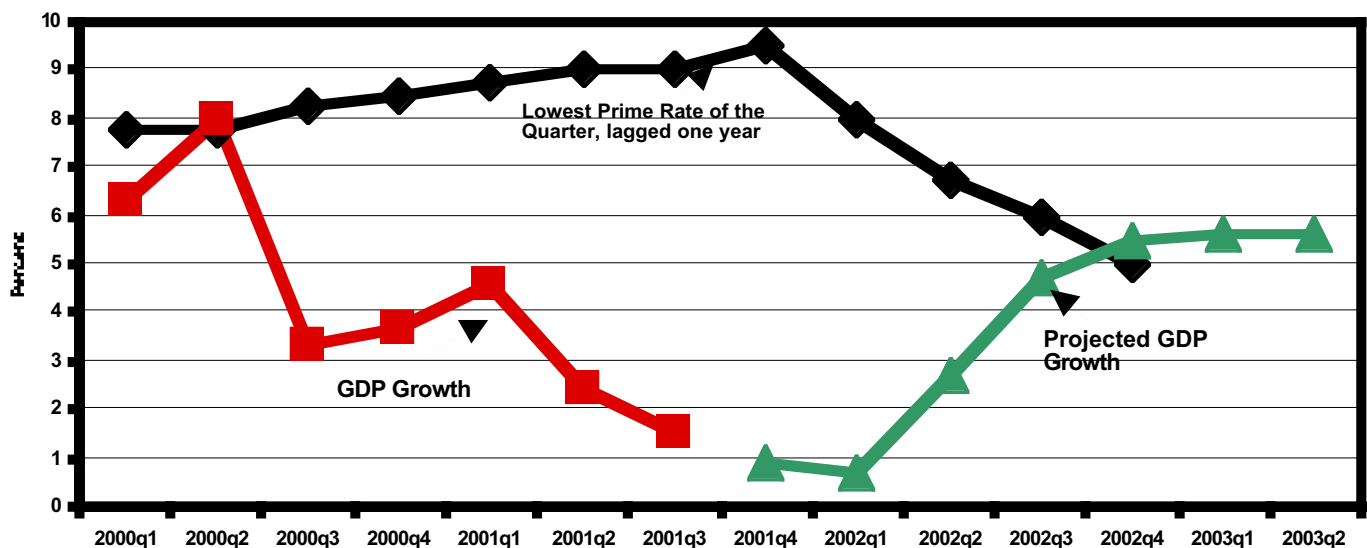


Two things in the chart are worth mentioning. Consider the observation for September 2001. In spite of the 911 tragedy, there is no sharp reduction in housing construction permits issued in the three S.C. metro areas. Why might this be the case? For one thing, permits do not mean expenditures. They imply future expenditures. These can be postponed if necessary. Plans for housing seemed to be unaffected by the national tragedy. Now, focus on the chart's final observation, the one for October 2001. Housing permit values have taken off in the low country and upstate. It's business as usual in the central midlands. Apparently, the low interest rates are beginning to have a meaningful effect. In a few months, we should expect to see a lot of construction underway in two of the state's major regions.

The powerful effect of interest rate changes on overall economic activity can be seen in a fundamental way when we examine the operating path of the national economy. The next chart maps together three sets of data. First, there are data on the Prime interest rate for a series of quarters. Be careful when looking at these numbers. They are lagged one year. When the chart shows a date of 2000Q1, the interest observed is for 1999Q1. The idea here is that actions taking place in the present is conditioned by interest rates in effect a year ago. The next set of data is for actual GDP growth for the quarters marked on the horizontal axis. Finally, there are data for projected or future GDP growth.

### Interest Rates & Nominal GDP Growth

12/1/01



Back in November 1998, the Federal Reserve Board became concerned about the Great American Bread Machine's ability to produce wealth. There was just too much going on. There was fear of inflation. The Fed began to raise interest rates. We see this path in the chart. At first, GDP continued to expand. The Fed raised the rates some more. As the rates got higher, GDP growth began to fall. In fact, GDP growth headed to the basement. Almost in a panic, the Fed began to reduce rates. Those lower rates do not bring immediate change. There's about a one-year lag.

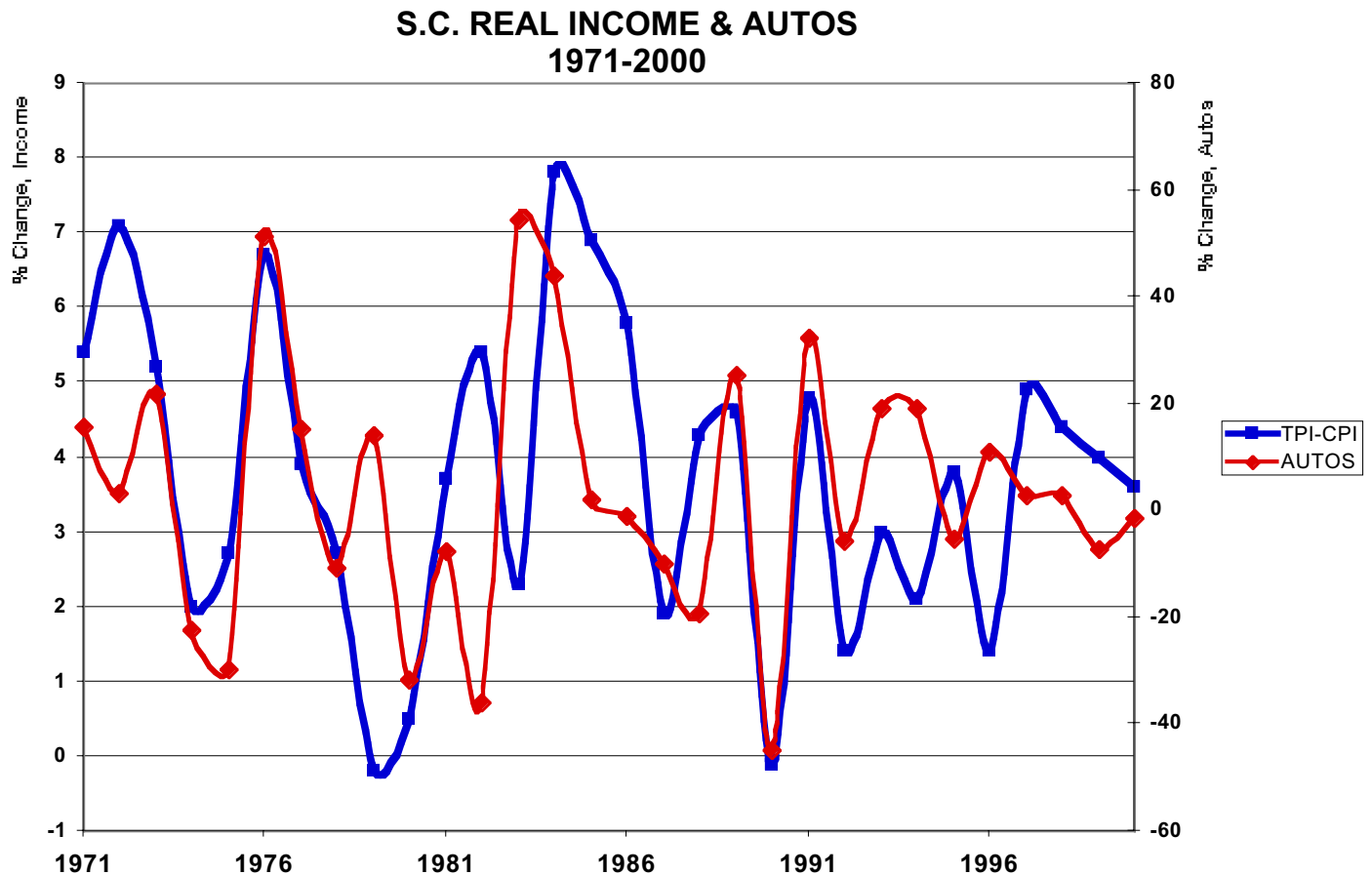
The chart shows the implication of all this. Rates have fallen. The cookies are in the oven. GDP growth is destined to rise again in the latter half of next year..., provided there are not intervening disasters.

The power of interest rates on the economy underlines the importance of careful and disciplined action on the part of the Fed. Even the best Federal Reserve Board will make policy errors that put the economy in the position of a yo-yo on a string. Over the last 10 years many analysts became convinced that the business cycle, those days of ups and downs, was dead. We no longer had to fret about having the rug pulled out from under us by an overly active central bank.

Unfortunately, the recession underway tells us that the business cycle is alive and well.

## **South Carolina's auto economy**

Long before BMW and Honda began to make cars in South Carolina, the state was an auto state. The list of component parts made in South Carolina was long and impressive. S.C. plants produced tires, upholstery, ignition and fuel systems, bearings, spark plugs, castings, everything but the completed cars themselves. As shown in the next chart, growth in S.C. real income followed the path of production of automobiles for the nation. To know one, was to know the other.



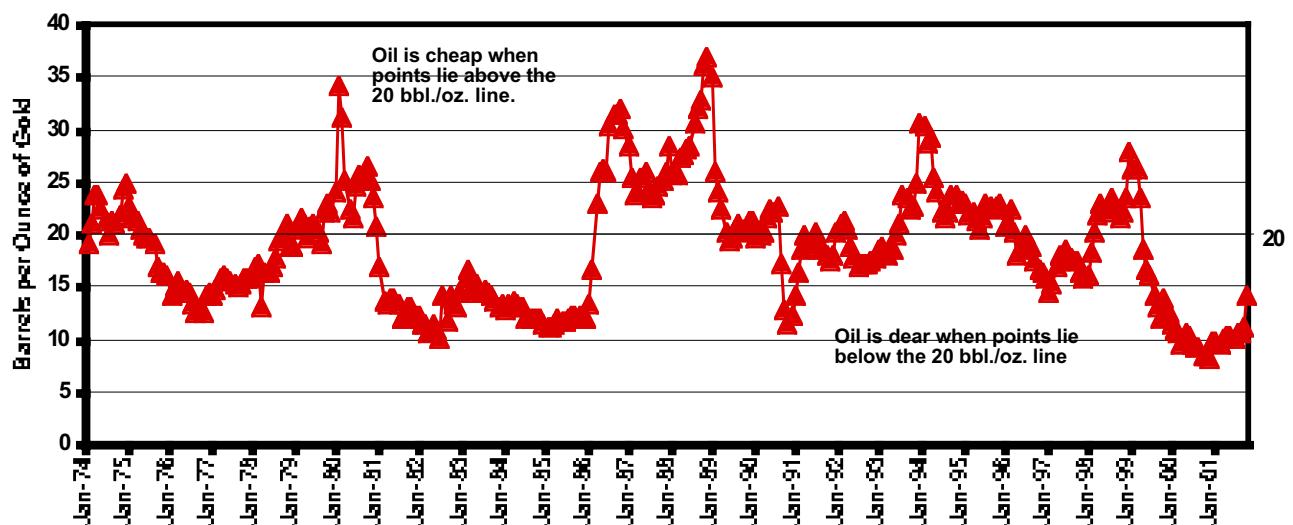
Close examination of the chart reveals two interesting features. First, in the earlier years, from 1971 through 1990, the fit between auto production and state income growth is very tight. Then, just when auto production actually takes place in the state, the fit weakens. The break between production and income corresponds to the fact that manufacturing, while vitally important in the state, no longer dominates the economy. A strong services economy has emerged that is joined by trade and tourism.

### **Gold and oil: The 20-barrel rule.**

As December rolled around, prices on the S.C. gasoline pumps finally fell below the dollar a gallon mark. After 911 travel plummeted. The iron law of supply and demand took its toll on energy markets. Prices fell. The decline in the price of heating oil, gasoline, and natural gas gave the average American household a larger gain in spending than the much vaunted tax refund.

For years, Arab oil traders have behaved as if they were swapping oil for gold. Interestingly enough, a golden rule emerged. One ounce of gold, no matter its price in dollars, would fetch 20 barrels of crude oil. The relationship between gold and its price and oil and its price since 1974 is shown in the chart below, where the 20-ounce rule is shown by the bold centerline.

**Gold and Oil: The 20 Bbl./Oz. Rule**



As can be seen, there are times when oil is too cheap, according to the rule. When that happens, one can predict that prices will rise. Then, there are times, when the gold price of oil is too dear. Following that period, the price of oil has declined.

We are in a period of high oil prices, at least in terms of gold. This suggests that we will see lower priced oil in the future.

You heard it here first.

***All best wishes for a wonderful holiday season.***